The outreach of microfinance in Sri Lanka is impressive when compared to many other developing countries. A study conducted by CGAP finds there are 15 million deposit accounts and 2 million micro loan accounts in a country of 20 million population.\(^2\) This is also corroborated by recent household survey findings that 78 percent have access to credit and 75 percent have access to savings; 66 percent have access to both.\(^3\) However, a significant percentage of the population remains without access to formal financial services and, even among those with access, the quality of that access is poor.

When the project's Village Self-help Learning Initiatives (VSLI) pilot was started in 1999, it did not envisage having a microfinance component. The project expected the communities to use the funds provided to create social infrastructure such as roads and water-supply. However, there was consistent demand from the participating communities for financing to support livelihoods-related activities. Contrary to the common perception that poor communities expect grants or “hand-outs” from Government funded projects, these community members were seeking sources of credit to improve their livelihoods. However, banks were seen as too distant and unwilling to provide credit to the poor and loans provided by Microfinance Organizations were available on prohibitive terms and conditions. As a result, borrowing from moneylenders at interest rates as high as 25\% per month was prevalent.

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\(^1\) Gemi Diriya in Sinhala means “village strength”.

\(^2\) Duflos and others (2006).

\(^3\) The Institute of Policy Studies (2005). The Survey interviewed 1,500 households from 50 Grama Niladhari divisions across 17 districts in Sri Lanka. The two largest providers are the Samurdhi program, the Sri Lankan government’s social welfare program, and SANASA, the financial cooperative network. Samurdhi offices are present in all Grama Niladhari Divisions and all villages have a Samurdhi worker.
The project management decided, therefore, to experiment by giving a Revolving Fund of Sri Lankan Rupee (SLR) 100,000 (US$ 923)\(^4\) to six villages. The results of this experiment were varied. Some village communities simply distributed the money among the villagers without any rules or guidance. Other communities developed some rules and procedures for the use of the money, but these were still inadequate to ensure sustainable performance of the fund. Following this, the project facilitated a participatory design process to address the shortcomings of the different approaches used and developed the Village Savings and Credit Organization (VSCO) model. This experience under the VSLI pilot was then scaled up under the Gemi Diriya program.

The Gemi Diriya approach supports the efforts of rural communities to identify, prioritize, and take action to meet their development needs by investing in autonomous organizations such as Village Organizations (VO) and their District Federations.\(^5\) The VO receives funds from the project and carries out activities prioritized by it. VOs are registered as “People’s Companies” under Sri Lanka’s Company’s Act (No.17 of 1982) and are governed by a General Assembly and Board of Directors (BOD). VOs receive facilitation, training, and technical assistance from the project to enable them to plan and implement activities in a participatory manner that includes women, youth, and the poor.

VOs receive a Village Development Fund based on the total population of the village.\(^6\) The VO then decides to allocate this fund among three components. The Capacity Building Fund is used to build capacity of the VOs and to maintain the VO offices; the Infrastructure Fund is used to create village infrastructure - such as roads and water supply - identified by the community as its highest priorities; and the Livelihood Fund is used to support livelihoods by providing loans for farm and non-farm activities, facilitating input and output linkages for economic activities, and providing one-time grants to the poorest. VO members have to

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\(^4\) At an exchange rate of 107.61 at the end of 2006.
\(^5\) The project is funded by the World Bank and implemented by the Gemi Diriya Foundation under the Ministry of Nation Building and Estate Infrastructure Development.
\(^6\) Currently, the amount is calculated at the rate of SLR 6000 (US$56) per individual in the village.
contribute at least 30% of the project costs in cash and labor for using the Infrastructure Fund.

As of December 2007, 866 VOs had been established by Gemi Diriya, with more than 80% of households becoming members through purchase of VO shares. Of the poorest households, 93% had become members of their VOs. Women held 60% of the decision-making positions on company Board of Directors and youth held 38% of positions. VOs have funded nearly 400 infrastructure projects.

**Village Savings and Credit Organizations**

The savings and credit activities of the VO are implemented by the Village Savings and Credit Organization (VSCO). VSCO is a three-tier entity, which is embedded within the VO but operates autonomously. VSCOs provide savings and credit services to VO members. To obtain these services, VO members have to become members of savings groups (SGs) and adhere to the rules and regulations of the VSCO.

**Services Offered**

VSCOs offer both savings and credit services. The two savings products are compulsory savings and voluntary savings. Each SG decides the amount of compulsory savings - they often range from SLR 30 to SLR 150 per month - and this allows even the poorest to join SGs.

The second main savings product is ‘normal savings’. This voluntary savings product enables members to save additional funds according to their means and needs. This savings is not lent out and is collected and deposited into banks. In addition, some VSCOs have developed additional special savings products such as Loan Security Fund.

**Box 1: Building up Savings**

Lalitha Padmakanthi is a member of the Kabillegama VO. She saves regularly in her SG and has accumulated a compulsory savings of SLR 2700 and a voluntary savings of SLR 5000.
Two main credit products are offered – one by the SGs (called ‘instant’ loans) and the other by the VO (termed ‘project loans’). SG instant loans are made by the SGs from the group's compulsory savings; and Village Savings and Credit Committee (VSCC) loans are made from the VO revolving fund. SG loans can be for any purpose, while loans from the VSCC are only for improving the livelihoods of members. They can be used for both the start-up and expansion of economic activities. The SG itself determines the size, interest rate and repayment period of SG loans, and makes all decisions concerning these loans. VSCC loans have terms established by the VO that owns the funds, and a decision-making process controlled by the VSCC.

Organizational Structure

Figure 1 shows the organizational structure of the VSCO. The basic unit in a VSCO is the Savings Group (SG). An SG consists of five to seven members. The members elect a chairperson and treasurer to manage SG activities and to represent the SG; they serve for two years. The treasurer maintains the accounts for SG compulsory savings and the lending of those savings.

Clusters are formed from a maximum of 6 SGs. The Cluster Committee (CC) is composed of the chairpersons and treasurers of each SG. The CC elects a Cluster chairperson, secretary and a treasurer to manage CC activities. The CC treasurer maintains the accounts for the voluntary savings of the SG members, and the CC banks those savings in a CC bank account used exclusively for this purpose.

A Village Savings and Credit Committee (VSCC), which is the highest level of governance within the VSCO, is formed by the chairpersons of the clusters, as well as two representatives of the VO’s BOD. The VSCC manages the loan fund owned by the VO. Prospective borrowers must have a viable business plan, on-time repayment of previous loans, regular savings within the SGs, and savings of at least 10% the value of the loan.

Figure 2: VSCO Structure

**KEY FEATURE: BOTTOM UP GOVERNANCE STRUCTURE**
Performance

VSCOs have achieved significant outreach and financial performance within a short period. Table 1 gives the performance of VSCOs as of December 2007. The Portfolio at Risk (30 days) indicator, which refers to all outstanding loans that have payments that are overdue by at least 30 days, is well within the limit of 5% which is considered to be international best practice.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Members in SGs</td>
<td>117,416</td>
</tr>
<tr>
<td>Savings mobilized</td>
<td>106.50</td>
</tr>
<tr>
<td>SG Loans Issued</td>
<td>44.80</td>
</tr>
<tr>
<td>VSCO Loans Issued</td>
<td>602.40</td>
</tr>
<tr>
<td>Interest Income</td>
<td>46.60</td>
</tr>
<tr>
<td>Portfolio at Risk (30 days) on VSCO Loans</td>
<td>2.80%</td>
</tr>
</tbody>
</table>

Amounts in Million SLR- Sri Lankan Rupee

Several VSCOs have shown excellent financial performance (Box 4).

Innovative features of VSCOs

User management: VSCOs are owned and managed by VO members who use VSCO services. Members determine savings norms and loan norms – amounts, interest rates, payment schedules, etc. The broad participation in VSCOs – over 60% of households in the project villages participate – makes VSCOs truly community-managed microfinance organizations.

Embedded Autonomy: The VSCO is not a separate legal entity; it is a self-managed part of the VO that is responsible for savings and loan operations.
These operations have been separated from other operations of the VO because experience in many countries has demonstrated that multi-sector organizations must clearly distinguish financial service activities from other activities such as infrastructure development. Furthermore, within a VSCO, the SG, the Clusters, and VSCCs also operate autonomously in their respective domains while being embedded in each other. The representatives from the VO Board of Directors in the VSCC helps to ensure that the loan fund owned by the VO is managed responsibly, thereby maintaining its full value over time.

Balancing safety and returns to savings: Most community-based savings and credit organizations use all the savings collected for lending purposes. This practice puts savings at risk if loans are not being fully repaid. However, when the poor save at banks, they often receive low interest rates on those savings, and the savings do not enable them to improve their access to loans from these institutions, forcing them to borrow from moneylenders at exorbitant interest rates. VSCOs strike a balance by using compulsory savings - which are the same for all members of an SG - for lending, but banking the normal savings, which vary according to the means and the desires of individual members. VSCOs establish relationships with banks so that members can get higher interest rates on their savings through fixed deposit instruments, and gain access to bank loans when they have established creditworthiness through on-time repayment of their VSCO loans. Also, by keeping management of normal savings at the Cluster level, where records and bank balances can be inspected by SG officers on a regular basis, the threat of savings mismanagement is significantly reduced.

Graduation of the poorest: Gemi Diriya allocates a portion of the Livelihood Fund for the provision of one-time grants of value SLR 5000 to 10,000(US$46 to US$92) for income generation to the poorest of the poor. This enables communities to help those with few assets to get started on an economic activity without the risk of a loan. The VO works with the poorest to help them develop a plan for a viable income generating activity before issuing the one-time grant. The grantee is expected to be an SG member and to be saving regularly. Being an SG member gives the grantee an opportunity to save additional income generated, provides a support group of similar people striving to move out of poverty, and most importantly, the possibility for future loans to scale up an existing economic activity or to start a new activity.

Risk-management: A Loan Security Fund, created at the VO level by a 1% fee paid by project loan borrowers and a 2% contribution by VSCO from interest income, is used to write off the loan in the case of a member’s death. The Fund also pays for the funeral expenses of the borrower. Gemidiriya field staff report that the existence of this fund is the most significant factor in attracting VO members to participate in VSCO activities.

Benefits

VSCO provides a simple and community friendly source of financial services for rural communities.

Providing an opportunity to save safely: VSCOs increase the number of people who have access to saving facilities in formal financial institutions. By placing their normal savings with banks, VSCOs are providing an opportunity for the rural poor to save safely. Further, there is a reduction in transaction costs of traveling long distances to Banks. VSCOs are increasing incentives to save and are encouraging a regular savings habit.

Providing timely credit at reasonable terms: VSCOs are offering credit that responds to the needs of VO members and is tailored to the complexities of rural lives, at terms that are decided by the users themselves. This contrasts starkly with the high interest rates and exploitative terms of credit offered by money lenders. The ‘instant’ loans provided by Small Groups address small and emergency credit and ‘project’ loans address

Box 5: From Destitution to Entrepreneurship

Sumanadasa is a member of the Wewatana VO. She got a grant of SLR 5000 in 2006 to start a micro-enterprise making and selling small packets of groceries such as tea, lentils and sugar. As the enterprise has done well, she has recently taken a loan of SLR 5000 to expand the activity further.
credit needs for livelihood improvement. VSCOs provide financial services to their members that are often not available from other sources. The economic impact of timely and adequate access to credit at reasonable terms can be significant. Credit offered for seasonal agriculture needs by several VSCOs is a good example.

Empowerment: Managing a financial institution of their own is a source of pride and self confidence to the communities. The domain which was earlier dominated mostly by rich men is now being handled by women.

**Vision for the Future**

VSCOs as a source of revenue to sustain VO's

Some VO's have already decided that a portion of the VSCO's profits will be transferred to the VO's to be used as development expenditure. This can become a sustainable source of revenue for VO's, once development funds provided to VO's by Gemi Diriya for infrastructure and capacity building are exhausted. This is critical since the mandate of the VO to help in the social and economic development of its members is unlikely to be achieved within the project period.

Ensuring the sustainability of VO's through federations

VO's are already starting to form federations as a means to leverage economies of scale and create sustainable access to support services. The financial services arms of these federations are expected to provide support services to VSCOs.

Achieving Financial Inclusion:

The formal financial system consisting of private and public banks, and other non-bank financial institutions in Sri Lanka, find it difficult to expand their outreach into rural areas and among the poor. Even publicly-owned
banks, which have a mandate to do this, find it hard to extend outreach to poor people cost-effectively. VSCOs are already helping them partially achieve their mandate by banking some of the savings collected. In the future, VSCOs can further help banks broaden and deepen financial inclusion by partnering with them in other financial services such as credit and insurance. Some banks have already expressed interest in establishing linkages with the VOs.

References